CHAPTER I. INTRODUCTION

The current individual income tax is widely perceived to be complex, unfair, and a contributing factor to a slowdown in national productivity and growth. Consequently, several fundamental alterations of the tax are receiving serious consideration. Most of the proposals for change would neither increase nor decrease the total yield of the tax, but they could be modified to raise additional revenues and narrow the deficit without depressing productivity and economic growth as much as raising the rates of the current tax would.

Opinion surveys report widespread dissatisfaction with the individual income tax and at least general support for major change. Thirty-six percent of the public feels that the federal income tax is the most unfair tax (compared to state income, state sales, and local property taxes).[1] Sixty-two percent of the public favors an income tax with a flat rate of 14 percent and very few deductions, although when polled on specific tax deductions, a majority advocated retaining most of the larger deductions.[2]

Many major tax reform bills have been introduced in Congress, most of which call for a flat tax rate or a progressive rate schedule and the elimination of all or most special tax deductions, exclusions, exemptions, and credits (called tax expenditures or tax preferences). Some members of

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1 According to a survey conducted by the Advisory Commission on Intergovernmental Relations, the federal income tax has been increasingly perceived to be the least fair of the four taxes. Nineteen percent of the United States public felt that the income tax was the least fair tax in 1972, 30 percent in 1973, 30 percent in 1974, 28 percent in 1975, 28 percent in 1977, 30 percent in 1978, 37 percent in 1979; and 36 percent in 1980, 1981, and 1982. (Advisory Commission on Intergovernmental Relations, Changing Public Attitudes on Governments and Taxes, 1982, p. 4.) Even so, 41 percent of the public feels that the federal income tax is fair, compared to 43 percent in 1978. (New York Times/CBS News Poll, New York Times (April 15, 1983).)

2 More than 50 percent of respondents favored retaining deductions for medical expenses, home mortgage interest, charitable contributions, state and local income and property taxes, casualty and theft losses, and state and local sales taxes. ("A Loss of Faith in the Progressive Tax," Business Week (September 6, 1982), p. 15.)

the Administration have endorsed this approach, and the Senate Finance Committee held hearings on it in September 1982.

This study surveys the pros and cons of the flat-rate, broad-based income tax approach and of two other proposals that have received more attention from economists than from the public: indexing the income tax completely for inflation and abolishing the current income tax and substituting a tax on consumption or expenditures.

SOURCES OF THE CURRENT DISCONTENT

Dissatisfaction with the current income tax is multifaceted. Apart from dissatisfaction with the level of taxation, which presumably would not abate if a different tax of equal yield were adopted, complaints center around the income tax's complexity; a perception that it is unfair and that tax evasion is on the rise; discontent with high marginal tax rates;[3] and concern about the tax treatment of capital income, particularly during periods of inflation.

High Marginal Tax Rates and Profusion of Tax Preferences

Partly to promote social goals like homeownership and energy conservation and partly to provide relief for taxpayers in a variety of situations, the Congress has enacted many tax preferences. As a result, the tax code is extremely complicated, and marginal tax rates are relatively high on the income that is taxed so that the desired level of revenues can be raised.

Complexity. About 40 percent of taxpayers seek professional help in filling out their tax returns, some because they cannot figure out how to do it themselves.[4] Moreover, many of those who prepare their own returns spend a substantial amount of time doing so.[5] In addition to the time spent

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3 The marginal tax rate is the percentage of tax collected on a dollar of additional income.

4 According to preliminary statistics, paid preparers filed 40.1 percent of all returns in 1982. (Telephone conversation with Dodie Reilly, Internal Revenue Service, May 25, 1983.)

5 Roughly 300 million hours are spent each year to fill out the 1040 and 1040A tax forms and supporting documents, according to the Office of Management and Budget (August 1982).

preparing returns, much time and effort is devoted to learning about tax provisions and planning financial decisions accordingly.

Administering the income tax is a formidable task. Demands on the Internal Revenue Service (IRS) are heavy--for information, revenue rulings, form preparation, and auditing. Monitoring compliance with each of the many complicated tax provisions is difficult, especially because the IRS is often pitted against financial experts who specialize in the various provisions.

Fairness. High statutory marginal tax rates may encourage some taxpayers to go "underground" or to make more intensive use of tax expenditures. Estimates of the underground economy's size and the associated loss in income tax revenue are necessarily unreliable, and they tend to vary widely depending on the estimation technique. The IRS has estimated that the revenue lost through noncompliance in the legal and illegal (drugs, gambling, prostitution) sectors by individuals and corporations has tripled in eight years--from $31.5 billion in 1973 to $95 billion in 1981.[6]

High marginal tax rates make it lucrative to seek legal ways to reduce taxes. As a result of some taxpayers modifying their behavior to reduce taxes and others finding themselves qualifying automatically for tax preferences, taxpayers with equal incomes pay widely different amounts of tax. Consequently, the income tax is not as progressive as is implied by the schedule of statutory tax rates. Many taxpayers thus feel that the tax is unfair; they believe that they pay more tax than the family next door with the same income, and that a family with higher income does not pay as much additional tax as it should.

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6 Statement of Roscoe L. Egger, Jr., Commissioner of Internal Revenue, before the Committee on Ways and Means (May 18, 1982), p. 4. A 1979 IRS study estimated the revenue loss from noncompliance in the legal and illegal sectors for 1976 was in the range of $19 billion to $26 billion. (See Internal Revenue Service, Estimates of Income Unreported on Individual Income Tax Returns (September 1979), pp. 11, 17.) The IRS is reviewing the 1981 estimates because some outside experts believed that they were too large. One study estimated that in 1976, between $4.5 billion and $6.7 billion in annual tax evasion was due to the increase in taxes that occurred between 1929 and 1976. (See Vito Tanzi, "Underground Economy and Tax Evasion in the United States: Estimates and Implications," p. 86, in Vito Tanzi, ed., The Underground Economy in the United States and Abroad (1982).)

Economic Distortions. The combination of high tax rates and a large number of tax preferences distorts economic decisions. A number of studies, reviewed in Chapter IV, suggest that the current tax reduces the overall levels of work effort, saving, and investment, and distorts the allocation of economic resources.

Problems in the Taxation of Capital Income

Many forms of capital income are currently exempt from income tax or receive preferential tax treatment, whereas other forms are taxed at rates above 100 percent in real terms--more than double the maximum statutory rate of 50 percent for interest income and five times the maximum effective rate of 20 percent for capital gains. The very high tax rates occur because the income tax is not indexed for inflation. For example, tax is due on capital gains from sales of assets whose prices rise in nominal value but actually fall in real value because they do not rise by as much as the general price level.

The Congress enacted several new tax incentives for saving and investment in the Economic Recovery Tax Act of 1981 (ERTA). It liberalized Individual Retirement Accounts, Keogh accounts, and depreciation, and authorized tax-exempt "All Savers' Certificates" and an exclusion from taxable income of 15 percent of net interest received. The changes reflected an expressed concern that Americans save less than is socially desirable, partly because the tax system itself discourages saving, particularly during inflationary periods.

These ad hoc changes, grafted onto a tax system that already had widely varying tax rates on different kinds of saving, may impede the flow of resources to their most productive uses and aggravate the perception that the income tax is complicated and unfair. The net result may be lower-than-potential economic growth. In addition, because much saving is now exempt from tax while interest on borrowing is tax deductible, many taxpayers can profit by borrowing to invest in tax-exempt savings accounts.[7] While this kind of behavior (called "arbitrage") reduces taxes for those who engage in it, it does not increase total saving, it wastes resources in the transactions, and it costs the government revenues.

As shown in Table 1, effective tax rates on new investment vary widely depending on the asset, the industry, the source of financing (debt

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7 Although tax law disallows deductions for interest paid on debt used to purchase tax-exempt securities, the provision is difficult to enforce since borrowed money is fungible.

TABLE 1. EFFECTIVE MARGINAL TAX RATES ON CAPITAL INCOME FOLLOWING THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (In percents)[a]

Capital Income	Inflation Rate		
	Zero	6.77	10.00
Asset			
Machinery	-0.3	11.0	15.7
Buildings	27.4	33.2	34.7
Inventories	50.9	47.0	45.5
Industry			
Manufacturing	38.4	46.4	49.0
Other industry	7.9	11.4	12.4
Commerce	29.6	30.5	30.5
Financing			
Debt	-8.9	-23.5	-29.1
New issues of stock	57.8	87.7	101.2
Retained earnings	43.9	57.3	61.7
Owner			
Household	39.7	52.7	57.2
Tax-exempt institution	-3.5	-29.8	-45.3
Insurance company	-3.0	17.3	39.2
Overall	28.7	31.5	33.0

SOURCE: Mervyn King and Don Fullerton, eds., "The United States," The Taxation of Income from Capital, Discussion Paper No. 37 (Princeton University, Woodrow Wilson School of Public and International Affairs, December 1982), Figure 6.28.

a. Present value of federal income tax, state income tax, and state and local property tax paid as percentage of the return to one dollar of additional investment on the part of all owners of the specified asset. (Assumes all investments begin with a 10 percent pretax return.) For an explanation of the economic model used to generate these results, see Mervyn King and Don Fullerton, eds., "The Theoretical Framework," in The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden, and West Germany, Discussion Paper No. 36 (Princeton University, Woodrow Wilson School of Public and International Affairs, December 1982).

or equity), the owner (household, tax-exempt institution, or insurance company), and the inflaton rate. Although some capital income is taxed at extremely high rates, some is actually subsidized, as indicated by the negative entries in Table 1.

MAJOR PROPOSALS FOR CHANGE AND PLAN OF THE REPORT

The problems posed by the combination of a large number of tax preferences and high marginal tax rates could be met head on by eliminating tax preferences (this is called broadening the tax base) and reducing tax rates. The rates could be reduced to one rate for all taxpayers--a flat rate--or to a new set of graduated marginal tax rates.

The current problems in capital income taxation could be dealt with comprehensively in two ways--by taxing consumption rather than income or by indexing the income tax base for inflation. Since a consumption tax is an income tax with an exemption for all saving, it does not tax the return to saving and hence does not favor one form of saving over another or distort investment decisions. Moreover, as will be explained below, none of the serious problems that inflation poses for an income tax would exist under a consumption tax.

If the income tax is retained, the distortions caused by inflation for the taxation of capital income could be eliminated by indexing capital gains, interest income and expense, depreciation, and costs of materials. This kind of indexing, called "tax-base indexing," converts the value of these items to constant dollars, so that, rather than being measured in nominal terms as they are now, they would be measured in real terms. Tax-base indexing would probably be accompanied by elimination of some or all tax preferences for saving and investment.

The report begins in Chapter II with a brief discussion of the evolution of the individual income tax. Chapter III sets forth the criteria for evaluating the income tax and proposals to change it. The major options for change are discussed in the remaining chapters. Chapter IV deals with broadening the income tax base and reducing tax rates, Chapter V with indexing the income tax base for inflation, and Chapter VI with taxing consumption. Chapter VII contains a short conclusion.

CHAPTER II. EVOLUTION OF THE INDIVIDUAL INCOME TAX

Current problems with the individual income tax are perhaps better understood by placing today's tax in a historical perspective. Recent interest in broadening the tax base and reducing tax rates would be readily explained, for instance, if it could be shown that the tax base has been consistently eroding and tax rates consistently inching upward over the past decade or two. Unfortunately, no such easy explanations are forthcoming.

As discussed below, the average rate of individual income taxation for the nation as a whole has increased, but not dramatically, since World War II.[1] The dispersion in average and marginal tax rates also has increased since 1960, with marginal tax rates now higher for most high-income taxpayers and lower for low-income taxpayers. Although less than half of personal income is currently subject to income taxation, this is not particularly low by post-World War II standards. The methods by which income is sheltered from taxation have changed markedly, however, over this period. In 1947, personal exemptions and standard deductions accounted for roughly half of all income not subject to tax. Between 1947 and the present, the relative value of personal exemptions was sharply eroded, and the number and use of special exclusions, itemized deductions, and credits increased dramatically. One of the most significant changes in the individual income tax during the postwar period was the growth of these special tax preferences.

This chapter highlights key aspects of the evolution of the individual income tax. It summarizes trends in the overall yield of the tax, the size and composition of the tax base, and levels of average and marginal tax rates. The chapter concludes with a discussion of the changes contained in the Economic Recovery Tax Act of 1981.

HISTORICAL PERSPECTIVE OF THE INDIVIDUAL INCOME TAX

Growth in Tax Receipts

Income was first taxed in the United States for a few years during and after the Civil War but then not again until 1913 following ratification

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1 The average tax rate is the percentage of total income taken in tax.

of the Sixteenth Amendment. The individual income tax in America has always had graduated marginal rates.[2] In 1913, tax rates ranged from 1 to 7 percent. Less than 1 percent of the population had to pay the tax, which yielded only one-tenth of one percent of personal income.[3] Until World War II, the income tax applied to a small percentage of the population (under 10 percent), and yielded less than 2 percent of personal income. By 1945, however, nearly three-quarters of the population was covered and about 10 percent of personal income was paid in tax.[4]

Since World War II, revenue from the individual income tax has remained between 7 and 12 percent of personal income.[5] The ratio of receipts to income was highest during the Korean and Vietnam Wars, although the gradual upward trend in receipts that began in 1975 culminated with receipts in 1981 matching the previous high of 12 percent of personal income reached in 1969, as shown in Table 2. In comparison, receipts from social insurance taxes rose much faster, from 3 percent of personal income in 1947 to 8 percent in 1981.[6] The individual income tax contributed between 40 and 45 percent of total federal receipts during most of the post-World War II period, as shown also in Table 2.

The individual income tax is the largest source of federal revenues. It yielded about $300 billion in fiscal year 1982 and is expected to remain at roughly that level for 1983. Social insurance taxes, the next largest

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2 Other countries have had flat-rate personal income taxes. The experiences in Great Britain from 1842 to 1880 and currently in Hong Kong are described in Robert Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (New York: McGraw Hill Book Company, 1983).

3 Richard Goode, The Individual Income Tax (Washington, D.C.: The Brookings Institution, 1976), pp. 3-4.

4 Ibid., p. 4.

5 State and local individual income tax receipts have grown significantly since World War II, from 0.4 percent of personal income in fiscal year 1950 to 2.0 percent in fiscal year 1982. Federal individual income tax receipts declined from 95 percent of federal, state, and local individual income tax receipts in fiscal year 1950 to 85 percent in 1982. (Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism 1981-1982 (April 1983), pp. 30-31.)

6 Department of Commerce, Bureau of Economic Analysis, "National Income and Product Accounts of the United States," Survey of Current Business (September 1981 and April 1982).

TABLE 2. GROWTH OF THE INDIVIDUAL INCOME TAX, SELECTED CALENDAR YEARS 1930-1981

Year	Individual Income Tax As a Percentage of	
	Personal Income	Total Federal Receipts
1930	1.4	34.3
1935	0.9	14.3
1940	1.3	11.7
1945	10.9	43.5
1950	7.7	34.8
1955	9.8	41.9
1960	10.4	43.5
1965	9.4	41.1
1969	12.1	46.5
1970	11.0	46.3
1972	10.8	45.2
1974	10.8	43.9
1976	10.2	42.7
1978	10.9	43.9
1980	11.6	46.4
1981	12.0	46.3

SOURCE: Department of Commerce, Bureau of Economic Analysis, "The National Income and Product Accounts of the United States," Survey of Current Business (September 1981), pp. 73-75, 122-123; (July 1982), pp. 12, 47.

source of revenue, produced only about two-thirds that amount in 1982, and corporate income taxes brought in only about $49 billion in fiscal year 1982 and are expected to drop to $40 billion in 1983.[7]

Although the average tax rate of the individual income tax for the population as a whole did not increase much during the post-World War II period, both the tax base and rate structure underwent major changes during that period.

Changes in the Tax Base

Between calendar years 1947 and 1979, the tax base (income taxed at a positive rate) was consistently half or less of personal income. The tax base grew from 40 percent of personal income in 1947 to 51 percent in 1969 and then fell back to 46 percent in 1979.[8] The difference between personal income and the tax base results from tax exemptions, exclusions, deductions, unreported income, and income offset by tax credits. The relative importance of these items changed dramatically from 1947 to 1979.

Personal exemptions decreased sharply as a percentage of personal income between 1947 and 1979, as did the category of income of nontaxable individuals and income not reported to the IRS, as shown in Table 3. On the other hand, income excluded from tax--mostly government transfer payments, fringe benefits, and interest on tax-exempt bonds--increased sharply. Itemized and standard deductions and income offset by tax credits also rose as a percentage of personal income.

Not only did the use of existing tax expenditures increase sharply during the postwar period, but many new preferences were enacted. For instance, the number of provisions giving special individual or corporate tax relief increased from 50 in 1967 to 104 in 1982.[9]

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7 Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983), p. 24.

8 Eugene Steuerle and Michael Hartzmark, "Individual Income Taxation 1947-1979," National Tax Journal (June 1981), p. 162.

9 Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986 (September 1981), p. 8.

TABLE 3. COMPOSITION OF PERSONAL INCOME NOT SUBJECT TO TAX (NOT PART OF THE TAX BASE), CALENDAR YEARS 1947 AND 1979 (As percentage of personal income)

	1947	1979	Change Between 1947 and 1978
Personal Exemptions	23.3	7.7	-15.6
Income of Nontaxable Individuals and Nonreported Income[a]	19.6	9.4	-10.2
Net Exclusions[b]	9.1	18.4	+9.3
Itemized Deductions	3.7	9.1	+5.4
Standard Deductions	4.5	6.7	+2.2
Income Offset by Credits	0.0	5.2	+5.2
Total Income Not Subject to Tax	60.2	56.4	-3.6

SOURCE: Eugene Steuerle and Michael Hartzmark, "Individual Income Taxation 1947-1979," National Tax Journal (June 1981), pp. 161-162, 165.

NOTE: Details may not add to totals because of rounding.

a. Adjusted gross income on nontaxable returns and the difference between adjusted gross income estimated by the Bureau of Economic Analysis (BEA) and that reported to the IRS. This difference is made up of income not reported to the IRS by those who file tax returns, income of nonfilers, and the residual of differences between the IRS and BEA measures of other variables.

b. Nontaxable transfer payments, fringe benefits, interest on tax-exempt bonds, deposits to Individual Retirement Accounts, moving expenses, and other income excluded from tax.

TABLE 4. DISTRIBUTION OF TAX RETURNS BY MARGINAL TAX RATE,[a] CALENDAR YEARS 1961, 1969, 1979 (In percents)

Marginal Tax Rate	1961	1969	1979
0 - 14	0.00	9.59	10.06
15 - 19	0.00	16.97	24.70
20 - 22	87.80	9.38	19.94
23 - 31	10.04	57.48	27.36
32 - 72	2.15	6.57	17.93
73 - 91	0.01	0.02	0.00
Total	100.00	100.00	100.00

SOURCE: Eugene Steuerle and Michael Hartzmark, "Individual Income Taxation 1947-1979," National Tax Journal (June 1981), p. 164.

a. Includes only tax returns with positive tax liability.

Changes in Marginal and Average Tax Rates[10]

Marginal Tax Rates. During the 1960s and 1970s, the Congress enacted several tax cuts, but "bracket creep," caused by the inflation of the 1970s, pushed taxpayers into higher marginal tax brackets even with no change in their real incomes.[11] In 1961, although statutory marginal tax rates were steeply graduated, ranging from 20 to 91 percent, the income tax was essentially a flat-rate tax for all but the highest-income taxpayers. As shown in Table 4, nearly 88 percent of taxpayers fell into marginal tax

10 The marginal tax rate is the percentage of tax collected on a dollar of additional income, whereas the average tax rate is the percentage of total income taken in tax. Since savings and work decisions are based partly on the after-tax return to additional effort, marginal tax rates are important in evaluating the effect of an income tax on these decisions. Average tax rates, on the other hand, indicate the overall burden of the income tax as a share of income.

11 Taxpayers were pushed into higher tax brackets when their real incomes increased as well.

brackets of 20 to 22 percent.[12] By 1969, 64 percent of taxpayers faced marginal tax rates above 22 percent. By 1979 marginal rates were sharply graduated--ranging from 14 to 70 percent--with 35 percent of taxpayers taxed at rates below 20 percent, and 18 percent at rates above 31 percent.[13]

The dispersion in marginal tax rates that occurred between 1960 and 1980 can also be observed by charting the rates at various points along the income distribution. The Treasury Department did this for taxpayers with median income, half median income, and twice median income.[14] The marginal income tax rate for four-person families at half median income dropped from 20 percent in 1960 to 14 percent in 1965 and then rose to 18 percent in 1980. Marginal rates for median income families rose from 20 percent in 1960 to 24 percent in 1980, and rates for families at twice median income increased from 22 percent in 1960 to 43 percent in 1980.

Average Tax Rates. Between 1954 and 1975, average tax rates decreased for low-income taxpayers, stayed about the same for middle-income taxpayers, and increased for those above the middle-income range. Families with real incomes of $15,000 and less (expressed in 1975 dollars) experienced declines in their average tax rates between 1954 and 1975; those with incomes of $20,000 in 1975 paid the same average tax rate in 1975 as they did in 1954; and those with higher incomes paid higher rates in 1975 than in 1954.[15]

The combined effects of bracket creep and the legislated tax cuts that occurred between 1967 and 1979 were studied by the Congressional

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12 Steuerle and Hartzmark, "Individual Income Taxation," p. 164.

13 Ibid., p. 164.

14 Department of Treasury, Office of Tax Analysis, April 13, 1981. Reprinted in Charles R. Hulten and June A. O'Neill, "Tax Policy," in John L. Palmer and Isabel V. Sawhill, eds., The Reagan Experiment (Washington, D.C.: The Urban Institute Press, 1982), p. 104.

15 Average tax rates are defined as tax liability divided by adjusted gross income. Comparing 1965 with 1975 tax rates yields basically the same result, with those in the $15,000 income group paying roughly the same average rate of tax in 1975 as in 1965, those with incomes less than $15,000 paying a lower average rate in 1975 than in 1965, and those with higher incomes paying a higher rate in 1975 than in 1965. (Benjamin Bridges, Jr., "Intertemporal Changes in Tax Rates," Social

Budget Office (CBO).[16] CBO compared the distribution of tax liabilities by income group under the tax law in effect in 1979 with the distribution that would have prevailed had 1967 law been kept in place but indexed automatically for inflation (indexed bracket widths, standard deduction, and personal exemption). Low-income taxpayers paid considerably less tax in 1979 than they would have had the income tax been indexed automatically for inflation, and upper-income taxpayers paid considerably more. Those in the $5,000-$10,000 income group, for instance, paid on average $148 less tax in 1979 than they would have under an indexed income tax, and those with incomes above $200,000 paid on average $15,000 more tax than they would have under indexation.

THE ECONOMIC RECOVERY TAX ACT OF 1981

Relative to the receipts that would have been collected in fiscal years 1982-1984 under a continuation of prior law, the 23 percent across-the-board marginal tax rate cuts and the reduction in top marginal tax rate from 70 to 50 percent embodied in the Economic Recovery Tax Act of 1981 (ERTA) were estimated to reduce revenues by about $178 billion.[17] Had no tax cut been enacted, however, inflation would have pushed taxpayers into higher tax brackets and increased the total yield of the individual income tax by roughly $57 billion over the same period, so about 30 percent of the tax cut can be viewed as an offset for anticipated inflation-induced tax increases.[18] Over fiscal years 1982-1985, the combination of bracket

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Security Administration, Office of Research and Statistics Studies in Income Distribution (June 1978), p. 7.)

16 Congressional Budget Office, Indexing the Individual Income Tax for Inflation (September 1980), p. 17.

17 Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1983), p. 238. The Economic Recovery Tax Act included reductions in income tax withholding rates of 5 percent in October 1981, 10 percent in July 1982, and 10 percent in July 1983. The cumulative rate reduction is 23 percent because of compounding (1 - 0.95 x 0.90 x 0.90) = 0.23).

18 The extent to which the tax cut can be thought of in this way depends greatly, of course, on future inflation rates and on the benchmark date from which the measurement is made. The result is particularly sensitive to the assumptions made about future inflation rates. In February 1982, CBO estimated that, without enactment of ERTA, bracket creep would have increased individual income tax revenues by $85 billion in fiscal years 1982-1984. The comparable figure of $57

creep and legislated increases in Social Security taxes will offset roughly half of the ERTA tax rate cuts.[19]

Considering only the marginal tax rate cuts and not the inflation-induced increase in taxes between 1981 and 1984, the rate reductions in ERTA would cause all individual income taxes in 1984 to be about 23 percent lower than they would have been without the tax cut. Comparing 1984 tax liability under ERTA to tax liability in 1981 under prior law, however, the reduction in real taxes paid will be 13.9 percent for families at twice the median income, 13.5 percent for those at the median income, and only 2.9 percent for those at half the median income. These lower figures reflect anticipated inflation-induced increases in taxes as well as the ERTA rate cuts. They also indicate that lower-income families will be hurt disproportionately by the failure of ERTA to increase the personal exemption and zero bracket amount and by the narrow widths of the tax brackets at low income levels. Real after-tax income in 1984 under ERTA will be greater than after-tax income in 1981 under prior law by 3.3 percent for families with twice the median income, 1.8 percent for those with median income, and 0.2 percent for those with half the median income.[20]

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billion cited in the text was calculated in February 1983 by CBO using the same technique, but is based on the lower inflation rates then being projected. The February 1982 estimate was based on annual increases in the CPI of 7.5 percent for calendar year 1982, 6.9 percent for calendar year 1983, and 6.9 percent for calendar year 1984, while the February 1983 estimate was based on increases of 6.1 percent for calendar year 1982, 4.5 percent for calendar year 1983, and 5.0 percent for calendar year 1984. (Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982), pp. 6 and 32; and Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983), p. 6.)

19 CBO estimates that over fiscal years 1982-1985 the tax rate reductions and indexing provisions of ERTA will reduce revenues by $287.8 billion; bracket creep that would have occurred over that period, had ERTA not been enacted, would have increased revenues by $103.9 billion; and the increase in employee contributions to Social Security will raise revenues by $23.5 billion. The Social Security tax increases exclude increases in the employer portion of the payroll tax, which will be about the same size as increases in the employee portion.

20 Tax liabilities are measured in 1981 dollars, and only the ERTA tax rate cuts are taken into account. Projections of income growth and inflation rates are Administration estimates reported in the 1983 budget. (Charles R. Hulten and June A. O'Neill, "Tax Policy," in John L. Palmer and Isabel V. Sawhill, eds., The Reagan Experiment, p. 117.)